MARKET UPDATE

Escalating Recession Fears Hit Markets

Equity markets fell sharply again last week, amid growing fears that the US economy may be facing a hard landing as a result of the Federal Reserve's monetary policy tightening to control inflation. Last Wednesday, US stocks suffered their worst one-day sell-off since June 2020, with the S&P 500 falling by 4%. Chinese economic data remains weak as strict lockdowns remain in force to combat the latest COVID-19 outbreak. The UK appears to be mired in stagflation while Europe isn't faring much better. And with no end in sight to the Russia-Ukraine war, geopolitical instability continues to weigh on the global growth outlook. Policy differences, with China cutting rates while the Fed raises rates, are compounding the uncertainty. The S&P 500 dropped by -3.0% last week and is now down -17.7% year to date. The Index was lower for the seventh straight week, its longest losing streak since 2001.The MSCI World Index is down by -17.2% so far this year.

While first-quarter company earnings reports have been generally strong, signs of weakness in some sectors are beginning to surface. Last week's sharp market declines were driven in part by negative surprises from US retail bellwethers Walmart and Target; weak earnings raised questions about the ability of companies to pass through cost increases and respond fast enough to shifting consumption patterns after the disruption of the pandemic. US consumer spending patterns remain robust, but consumers are struggling to cope with higher energy prices. And many consumer companies are facing margin pressure because of the dual consequences of higher energy and input prices, as well as an unfolding shift in consumer spending from goods to services.

Equity market volatility has fueled a flight to safe havens. For some investors, this has helped mitigate recent losses in government bond holdings, with the US 10-year government bond yield falling from 3.2% earlier this month to 2.8% on Friday. The US dollar's strength has also moderated losses for many non-US investors, although the dollar's rise has stalled in the last week or so.

Is the worst over? It's too soon to say. A US recession in 2022 is not AB economists' base case, but risks have clearly risen. The Fed may not be able to avoid tipping the US into recession as it seeks to reduce demand enough to get inflation back within its target range. Still, if the US economy does slide into recession, we believe it could be relatively mild. Company, household and bank balance sheets are strong. Developed market economies generally are not suffering from the major excesses or imbalances on the scale of those that triggered a severe recession during the 2008/09 Global Financial Crisis. Nominal growth remains stronger than almost any period since the GFC, which supports corporate revenues. Tight labor markets—a big concern to the Fed—have a silver lining in the form of higher wages that can help sustain consumer spending power.

Equity Markets: A Painful but Healthy Process

Still, current market convulsions reflect an unwinding of two distortions that have been prominent in financial markets in recent years as a result of ultra-accommodative monetary policies. First, the collapse of speculative assets, such as high-flying growth stocks with little or no profits and cryptocurrencies; in some respects, this resembles the bursting of the dotcom bubble in 2000. Second, the monetary stimulus has combined with supply shortages to fuel inflation. Over time, this is a painful but healthy process that will ultimately lay a strong foundation for a more balanced market recovery, in our view.

The equity market sell-off has been led by the most expensive stocks. But valuation spreads between the cheapest and most expensive stocks have corrected from levels that were well above historical average. Equity valuations are adjusting to a less supportive monetary policy environment, and it is hard to predict when this process will run its course. However, this challenging environment also creates conditions for active portfolio managers to thrive. Extreme volatility often leads to the mispricing of securities, which active managers can exploit, using fundamental research to identify companies that are better positioned to perform well over the long term.

Fixed Income Markets: Credit Fundamentals Remain Solid

While declines in bond markets have been more orderly, the last few months have been difficult for fixed income investors. Treasuries and corporate credit have sold off and spreads and yields have risen. For example, the Bloomberg US Corporate Index is down -12.5% this year through May 20 while the Bloomberg Global High Yield Index had dropped -11.1% and the Bloomberg US High Yield Index is down -11.0%. But by the same token, valuations are much more attractive. And high-yield spreads are at their widest since the onset of the pandemic.

We see opportunities in credit markets, especially high yield, for two main reasons. First, despite the backup in yields and spreads, corporate fundamentals remain very solid, a point reinforced by companies' first-quarter 2022 earnings reports. Companies started the year in really strong fundamental shape and, while we expect corporate fundamentals to erode somewhat over the coming quarters, we believe most companies have the capacity to absorb a good deal of economic weakness. Second, starting yields have historically been a remarkably reliable indicator of future returns over the next five years—no matter how volatile the environment.

With credit yields currently at attractive levels, we think investors buying now and holding patiently will be rewarded over time. In a portfolio context, credit also has strong diversifying properties versus equities and historically has rebounded earlier during recovery periods.

Meanwhile, however, market technicals remain weak, as corporate credit has experienced a steady stream of outflows for most of the year. Issuance also remains muted, with investment-grade volumes down approximately 5% and high-yield issuance down over 70% year over year. Overall liquidity is a little lower over the last few months amid the market volatility. But markets generally remain very orderly with limited "panicked" selling. We believe the market has already priced in a lot of downside risk. Companies that report poor results, though, may still be sold off, as evidenced by several names over the last week.

Balanced Exposures
Generally risk markets usually start to recover before economies do, often when sentiment is at its most negative. Maintain a balanced set of exposures across and within asset classes.

In equities, while more expensive companies have suffered greater multiple contraction and declines year-to-date, we believe that growth companies offering long-term, less cyclical earnings could come back into favor again as the market's primary concern shifts from inflation to potential recession. We prefer balanced allocations across equity styles, that emphasize discipline on valuations and conviction in the continued profitability of business models that can perform well even if the economic cycle deteriorates. We consider that lower-volatility equity strategies that target high-quality stocks with stable earnings patterns trading at attractive valuations may also help investors stay in stocks while reducing risk.

For bond investors, we continue to believe in the advantages of a balanced portfolio that dynamically manages interest-rate and credit risk, as this may improve risk-adjusted returns over time. This approach combines sovereign and other higher-rated debt with non-investment-grade credits in a single, risk-managed portfolio. Such a portfolio has the potential to capture the majority of potential return provided by high-yield markets, but with much smaller drawdowns than a dedicated high-yield portfolio. It can also ensure liquidity in times of market stress, enabling investors to readily rebalance back from safer investment-grade securities into high-yield credits when attractive entry points arise.

Focus on Long-Term Strategic Goals
Extreme market volatility is distressing for investors, especially with so much uncertainty on multiple fronts. At times like these, it's important to refrain from panic selling that would lock in losses. Periods of stress serve to clarify investors' risk tolerance. Sticking to a well thought-out, strategic, long-term investment plan, aligned with an investor's financial goals and risk appetite, is the key to success, in our view. It's also worth noting that recoveries from bear markets offer fertile ground to generate strong returns, so investors with dry powder may want to consider an increasing number of attractive long-term investment opportunities.

AB's portfolio management teams will remain vigilant in avoiding uncompensated risks in portfolios and attentive to new security-specific opportunities across asset classes. For information about performance and positioning in specific portfolios, please contact your advisor.

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

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